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Ten Principles of Economics

PRINCIPLES OF
ECONOMICS
FOURTH EDITION

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PowerPoint® Slides
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In this chapter, look for the answers to these questions:

§ What kinds of questions does economics address?

§ What are the principles of how people make decisions?

§ What are the principles of how people interact?

§ What are the principles of how the economy as a whole works?

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What economics is all about

§ Scarcity

§ Economics

- how people decide how much to work, save, and spend, and what to buy
- how firms decide how much to produce, how many workers to hire
- how society decides how to divide its resources between national defense, consumer goods, protecting the environment, and other needs

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HOW PEOPLE MAKE DECISIONS

§ Decision-making is at the heart of economics.

§ The first four principles deal with how people make decisions.



HOW PEOPLE MAKE DECISIONS

Principle #1: People Face Tradeoffs

All decisions involve tradeoffs. Examples:

§ Going to a party the night before your midterm leaves less time for studying.

§ Having more money to buy stuff requires working longer hours, which leaves less time for leisure.

§ Protecting the environment requires resources that might otherwise be used to produce consumer goods.

HOW PEOPLE MAKE DECISIONS

Principle #1: People Face Tradeoffs

§ Society faces an important tradeoff:
efficiency vs. equity

§ **efficiency:**

§ **equity:**

§ Tradeoff:

HOW PEOPLE MAKE DECISIONS

Principle #2: The Cost of Something Is What You Give Up to Get It

- § Making decisions requires comparing the costs and benefits of alternative choices.
- § The **opportunity cost** of any item is

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HOW PEOPLE MAKE DECISIONS

Principle #2: The Cost of Something Is What You Give Up to Get It

Examples:

The opportunity cost of...
...going to college for a year

...seeing a movie

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HOW PEOPLE MAKE DECISIONS

Principle #3: Rational People Think at the Margin

- § A person is **rational** if
- § Many decisions are not "all or nothing," but involve **marginal changes** –
- § Evaluating the costs and benefits of marginal changes is an important part of decision-making.

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HOW PEOPLE MAKE DECISIONS

Principle #3: Rational People Think at the Margin

Examples:

- § A student considers whether to go to college for an additional year, comparing
- § A firm considers whether to increase output, comparing

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HOW PEOPLE MAKE DECISIONS

Principle #4: People Respond to Incentives

§ **incentive:**

§ Rational people respond to incentives because they make decisions by comparing costs and benefits. Examples:

- In response to higher gas prices, sales of “hybrid” cars (e.g. Toyota Prius) rise.
- In response to higher cigarette taxes, teen smoking falls.

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ACTIVE LEARNING 1: Exercise

You are selling your 1996 Mustang. You have already spent \$1000 on repairs.

At the last minute, the transmission dies. You can pay \$600 to have it repaired, or sell the car “as is.”

In each of the following scenarios, should you have the transmission repaired?

- A. Blue book value is \$6500 if transmission works, \$5700 if it doesn't
- B. Blue book value is \$6000 if transmission works, \$5500 if it doesn't

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ACTIVE LEARNING 1: Answers

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HOW PEOPLE INTERACT

§ An “economy” is just a group of people interacting with each other.

§ The next three principles deal with how people interact.



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HOW PEOPLE INTERACT

Principle #5: Trade Can Make Everyone Better Off

§ Rather than being self-sufficient, people can specialize in producing one good or service and exchange it for other goods.

§ Countries also benefit from trade & specialization:

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HOW PEOPLE INTERACT

Principle #6: Markets Are Usually A Good Way to Organize Economic Activity

§ A market

§ “Organize economic activity” means determining

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HOW PEOPLE INTERACT

Principle #6: Markets Are Usually A Good Way to Organize Economic Activity

§ In a market economy, these decisions result from the interactions of many households and firms.

§ Famous insight by Adam Smith in *The Wealth of Nations* (1776):
Each of these households and firms

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HOW PEOPLE INTERACT

Principle #6: Markets Are Usually A Good Way to Organize Economic Activity

§ The invisible hand

- The interaction of buyers and sellers determines prices of goods and services.
- Each price
- Prices guide self-interested households and firms to make decisions that, in many cases, maximize society’s economic well-being.

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HOW PEOPLE INTERACT

Principle #7: Governments Can Sometimes Improve Market Outcomes

§ Important role for govt:

§ People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.

- A restaurant won't serve meals if customers do not pay before they leave.
- A music company won't produce CDs if too many people avoid paying by making illegal copies.

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HOW PEOPLE INTERACT

Principle #7: Governments Can Sometimes Improve Market Outcomes

§ Govt may alter market outcome to

§ **market failure**

- **externalities,**
- **market power,**

§ In such cases, public policy may increase efficiency.

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HOW PEOPLE INTERACT

Principle #7: Governments Can Sometimes Improve Market Outcomes

§ Govt may alter market outcome to

§ If the market's distribution of economic well-being is not desirable,

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ACTIVE LEARNING 2: Discussion Questions

In each of the following situations, what is the government's role? Does the government's intervention improve the outcome?

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HOW THE ECONOMY AS A WHOLE WORKS



§ The last three principles deal with the economy as a whole.

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HOW THE ECONOMY AS A WHOLE WORKS

Principle #8: A country's standard of living depends on its ability to produce goods & services.

§

- Average income in rich countries is more than ten times average income in poor countries.
- The U.S. standard of living today is about eight times larger than 100 years ago.

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HOW THE ECONOMY AS A WHOLE WORKS

Principle #8: A country's standard of living depends on its ability to produce goods & services.

§ The most important determinant of living standards:

§ Productivity depends on

§ Other factors (e.g. labor unions, competition from abroad) have far less impact on living standards.

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HOW THE ECONOMY AS A WHOLE WORKS

Principle #9: Prices rise when the government prints too much money.

§ **Inflation:**

§ In the long run, inflation is almost always caused by

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HOW THE ECONOMY AS A WHOLE WORKS

Principle #10: Society faces a short-run tradeoff between inflation and unemployment

§ In the short-run (1 – 2 years),

§ Other factors can make this tradeoff more or less favorable, but the tradeoff is always present.

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FYI: How to read your textbook

1. Summarize, don't highlight.

Highlighting is a passive activity that won't improve your comprehension or retention. Instead, summarize each section in a few sentences of your own words. When you finish, compare your summary to the one at the end of the chapter.

2. Test yourself.

Try the "QuickQuiz" that follows each section before moving on to the next section. Write your answers down, and compare them to the answers in the back of the book. If your answers are incorrect, review the section before moving on.

FYI: How to read your textbook

3. Practice, practice, practice.

Work through the end-of-chapter review questions and problems. They are often good practice for the exams. And the more you use your new knowledge, the more solid it will become.

4. Go online.

The book comes with excellent web resources, including practice quizzes, tools to strengthen your graphing skills, helpful video clips, and other resources to help you learn the textbook material more easily and effectively.

FYI: How to read your textbook

5. Study in groups.

Get together with a few of your classmates to review each chapter, quiz each other, and help each other understand the material in the chapter.

6. Don't forget the real world.

Read the Case Studies and In The News boxes in each chapter. They will help you see how the new terms, concepts, models, and graphs apply to the real world. As you read the newspaper or watch the evening news, see if you can find the connections with what you're learning in the textbook.

Conclusion

- § Economics offers many insights about the behavior of people, markets, and economies.
- § It is based on a few ideas that can be applied in many situations.
- § Whenever we refer back to one of the **Ten Principles** from this chapter, you will see an icon like this one:


